UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Natural Gas Pipeline Negotiated Rates, Policies and Practices	))	**Docket No. PL02-6-000**

COMMENTS OF MICHIGAN AND THE MICHIGAN PUBLIC SERVICE COMMISSION

Pursuant to the Notice of Inquiry issued in the captioned proceeding on July 17, 2002, the State of Michigan and the Michigan Public Service Commission (collectively "Michigan"), hereby submits its comments on the Commission's negotiated rate policies.

COMMENTS

In 1996, the Commission authorized pipelines to utilize negotiated rates in order to provide pipelines additional flexibility to market pipelines capacity. The policy allows pipelines to negotiate rates with shippers that use different rate designs and to depart from cost-based rate structures, including rates based on price index differentials such as gas basis differentials or spark spreads.

The negotiated rate policy has provided pipelines serving the Midwest with needed flexibility to deal with capacity turnback issues and to respond to new demands for pipeline capacity. ANR Pipeline, Northern Natural Gas Company and Vector Pipeline all have utilized negotiated rates.

Negotiated rates have been instrumental in meeting the needs of the new market for independent electric power generation. Traditional pipeline recourse rates are designed such that 100 percent of the fixed costs are recovered in the reservation fee. The resulting high reservation rates discourage the construction of new gas-fired electric generation, especially those designed to operate at low capacity factors. Electric generators need a rate design which recovers fixed costs via other means. Negotiated rates have allowed the pipelines to address this market need by negotiated rate agreements that better meet generators' needs. The pipeline can agree to shift fixed costs from the reservation fee to the usage rate (or base the rate on an index). This rate structure facilitates financing and the construction of electric generation by reducing the risk of the generation not being able to recover the cost of the pipeline transportation service in a competitive electric power market.

If generators are not allowed to negotiate rates that closely relate to their market needs, then the Commission may create an unintended bias that favors transporting electricity via long distance electric transmission over locating more efficient gas-fired generation closer to the point where the power is consumed. This bias could occur, in the context of the Commission's proposed rulemaking in Docket No. RM01-12-000 to implement a Standard Market Design, if generation located closer to the market area must pay a distanced-based gas transmission rate but compete against generation located closer to the point of natural gas production, which does not pay a distanced-based electric transmission charge.[1] If the Commission continues to allow negotiated rate flexibility, generators will be better able to negotiate to eliminate such bias, creating a more competitive wholesale electric market.

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[1] The gas transmission rate may also be subject to the Commission's policy on incremental facilities, PL94-4-000 (Issued 5/31/95) which could further favor the use of natural gas for generation that is closer to the gas supply source, but farther from the point where the power is consumed. Under the Commission's proposed SMD, however, the electric transmission rate may be a postage stamp rate that includes the rolled in cost of new facilities that, while subject to the additional costs of losses and congestion, may remain more competitive than the gas transmission alternative. *Remedying Undue Discrimination Through Open-Access Transmission Service and Standard Electricity Market Design,* Notice of Proposed Rulemaking, Docket No. RM01-12-000, 67 Fed. Reg. 55452 at pps. 55474 and 55479 (August 29, 2002) ("SMD NOPR").

Negotiated rates have allowed suppliers of gas for electric power generation to negotiate transportation rates for gas supply based on price differentials which minimize transportation rates when location basis or spark differentials are low. Conversely, the transportation rates may exceed the pipeline's cost-based recourse rates when the rate differentials are high.

The Commission is concerned that negotiated rates based on pricing differentials may create an incentive for pipelines to manipulate the commodity market. Michigan does not support a prohibition on the use of price differentials because of the potential for abuse. The resulting loss of rate flexibility to power generators may harm competition. Rather than throwing the baby out with the bath water, the Commission should continue, as it has, to police abuse, *Transwestern Pipeline Co*., 100 FERC ¶ 61,058, and allow pipelines to continue their use of price differentials to set pipeline transportation rates. This rate flexibility is critical for power generators to ensure a competitive market as envisioned in the Standard Market Design NOPR in RM01-12-000.

The Commission should address the potential for excessive rates by advising shippers to negotiate rate caps in their agreements.

The Commission has specifically requested comments on whether any changes need to be made to the recourse rate structure. Michigan agrees that existence of a viable recourse rate is essential to mitigate the pipeline's exercise of market power. For this reason, Michigan supports a review and reconsideration of the straight-fixed variable recourse rate in light of the experience under the negotiated rates over the past six years. As indicated, negotiated rates have departed from the straight-fixed variable rate design in response to demands from the market. This suggests that the recourse rate should also be adjusted to reflect these market trends.

Another issue requiring further review is how pipelines are utilizing negotiated rates in connection with the pricing of newly constructed pipeline capacity. Pipelines have been relying increasingly upon negotiated rates to market major new pipeline capacity expansion projects. In markets where existing capacity is constrained and the value of capacity exceeds its actual cost of construction, pipelines may be motivated to seek shipper agreements to above-cost negotiated rates as a precondition to the pipeline's agreement to construct new capacity. In order to address this concern, the Commission should make clear that pipelines must provide an open season for all new capacity expansions which provides all shippers, including existing recourse shippers, with a non-discriminatory right to bid for newly constructed capacity at cost-based recourse rates, as well as negotiated rates.

In conclusion, Michigan submits that the negotiated rate policy has provided pipelines needed flexibility to respond to the changing market for natural gas pipeline capacity, particularly in the market for needed capacity to serve new gas-fired electric generation. Michigan supports a continuation of the negotiated rate program and urges the Commission to adjust the recourse rate to reflect market-based trends relating to the pricing of pipeline capacity.

Respectfully submitted,

STATE OF MICHIGAN and MICHIGAN PUBLIC SERVICE COMMISSION

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the foregoing document by first-class mail upon each party on the official service list compiled by the Secretary in this proceeding.

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David D'Alessandro